Electric Power Supply Association

Summer 2000: Urgent Steps to Restore Confidence in Electricity Markets

Remarks
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I. Introduction

There is a crisis of confidence in some electricity markets that demands our immediate attention. We must urgently search for solutions in order to continue the march toward competitive markets. Thus, this conference is critical and timely. In some regions, consumers do not believe that competition is producing benefits for them. They believe that there are price gouging, collusion and other sorts of nefarious activities by market participants. They are frightened by high and volatile prices. In California, wholesale prices this year are multiples of last summer's prices, and consumers don't care that it is hot and a low hydro year. They've experienced hot weather before, and didn't have to contend with these prices. The governor of California telephones the President, and follows up with a letter characterizing the issue as a "staggering rise in electricity prices."

In the Pacific Northwest, Tom Matthews, chairman of Avista Energy, was quoted recently in the Wall Street Journal as saying: "The big question is whether the whole market has taken a leap from $20-24 per MWh to $70-80. If it's permanent, then all the resource-based companies in the Northwest will be shut down." In the same article, the Montana Industrial Consumers trade group says its members paid 5 times more for power in June 2000 compared to June 1999. An

August 25 op-ed piece in the New York Times characterized market competition as "the electricity fiasco" and a "scary economic experiment." Many voices are raising alarms and we cannot afford to be tone deaf to these concerns. We must respond forcefully.

All eyes are on California. You know the adage: "As California goes, so goes the country." A recent article in MegawattDaily quoted a supporter of deregulation in Iowa as saying that events in California have ruined the climate for restructuring in the Iowa Legislature. A recent piece in the Arkansas Democrat Gazette said that the Arkansas General Assembly may now consider pushing back the effective date of the new electricity competition law from 2001 until 2005.

Obviously, this is not simply an issue of whether states will be deterred from retail choice. High wholesale power prices are ultimately passed through to retail customers. So even if a state chooses not to implement choice, high wholesale purchased power costs impact consumers.

I must admit that I have been surprised and shocked by the high and volatile prices we have experienced in some wholesale markets. Indeed, the Commission's primary rationale for promoting market-based policies is that markets will produce consumer benefits and lower prices compared to cost of service regulation. After all, Orders Nos. 436 and 636 on the gas side appeared to produce immediate benefits and lower prices for natural gas. Although gas prices have increased recently, for several years after Order 636 they were quite low. During our internal debates while finalizing Order No. 888, our economists were convinced that open access and wholesale competition in electric markets would cut wholesale prices immediately. In capacity starved areas, however, prices have been higher.

The midwest price spikes in 1998 were a wake up call for all of us, and I found the event to be extremely disturbing. But the report following the Commission's staff investigation seemed to downplay its significance, calling it an unusual combination of circumstances that is unlikely to reoccur. Perhaps that precise combination of circumstances has not reoccurred, but some volatile combination seems to occur regularly.

Following the 1998 spike, I gave speeches positing three distinct choices for the Commission. Number 1: turn the clock back, and declare wholesale competition a failure. There was no interest at the Commission in implementing such a policy. Choice number 2 was to tread water, meaning to rest on our Order 888 laurels and hope for the best. But treading water carried its own risks -- the risk of tolerating self dealing by transmission providers that also owned generation, inefficient transmission pricing, flawed power markets, the risk that the Commission, rather than being a bold problem solver, would become a mere passive observer of the marketplace. Choice number 3 was to move forward aggressively to ensure that the transmission grid is truly open and efficiently priced to provide a platform for vibrant regional power markets. The Commission tilted sharply toward choice number three, proposing the formation of regional transmission organizations. RTOs will be no panacea in solving all market problems, but they will certainly help, if they form.

Everyone is aware that the Commission has a statutory duty to ensure that wholesale prices are just and reasonable. This is the Commission's fundamental consumer protection responsibility, and the Federal Power Act provides no exception for flawed markets. It is my view that the Commission must reassure market participants, policymakers and consumers that we will insist that jurisdictional wholesale markets produce just and reasonable prices. If we fail to act decisively to provide this assurance, I fear that we will see the erosion of the political consensus necessary to sustain a market-based approach to regulation. The movement to competition will not endure if consumers do not see the potential in the form of lower prices, reliability and attractive services.

II. Paving the Road to Well-Functioning Competitive Markets

The question we should be asking ourselves is, given recent events, how do we move forward? What steps can we take to restore consumer confidence? Taking a laissez-faire approach, letting the markets police themselves, is not an acceptable answer in my view. We have strong indications that all of the elements necessary for well-functioning electricity markets are not yet in place. We must ensure that the road to market-based solutions and customer benefit is well paved, and we must proceed with a real sense of urgency.

You are aware that a few weeks ago we directed the FERC staff to conduct a thorough investigation of bulk power markets. That investigation is now focused primarily on California. I have urged staff to leave no stone unturned in understanding the nature of the problems we are facing, and in proposing solutions. The staff report is due November 1st. My observations and recommendations are made now without the benefit of the staff's conclusions, but here is my preliminary thinking.

First, policy makers must ensure that there are no impediments to expanding the supply of generation and transmission facilities. This is critical. Markets will not work if supply cannot enter easily in response to demand. Many of the high prices this year and in other years have been attributed to a shortage of generators, or to constraints in the transmission network that prevent cheaper power from reaching the markets with high prices. I recognize that some of these shortages were the result of unforeseen events, exceptionally hot weather or sustained demand growth due to the economy's continued strong performance. Nonetheless, necessary facilities must be sited and built for competitive markets to produce benefits. State siting authorities must respect this fundamental truth. Regulators must ensure that reasonable and time limited siting rules are in place, balancing the need for new generation capacity with a responsible environmental policy.

We also we need streamlined, standardized interconnection procedures and agreements to facilitate generation entry. I have been pushing for such a policy at the Commission. Interconnection legerdemain is anticompetitive and anticonsumer. But not all interconnection authority resides at the federal level. The interconnection of many generators, including many applications of distributed generation, is at the state level. We still have a lot of work to do in streamlining and standardizing interconnection procedures and agreements.

We also must ensure that there is adequate transmission capacity to support competitive markets. There are two aspects to this piece of the puzzle. One is to provide adequate incentives to encourage grid expansion. The Commission recently demonstrated its willingness to allow higher rates of return on transmission facilities. And I believe that performance-based rates and other incentives for RTO members will help to spur transmission investments. The other part of the transmission issue is siting. I am not confident that the current state-by-state approach to siting interstate transmission facilities will get the job done. I believe that the siting of interstate facilities should be carried out by an interstate authority. I continue to strongly recommend federal siting authority with the power of eminent domain. This is one of the issues on which I agree with Chairman Murkowski of the

Senate Energy and Natural Resources Committee. FERC has such authority with respect to interstate gas pipelines and we have certificated thousands of miles of new pipeline capacity over the last few years.

A second broad area that we need to focus on is market design. We've learned a lot about electricity markets in the last year or so. One important lesson is that market power can be exercised for very limited times during extreme demand conditions with very dramatic price impacts. In some high demand periods, it is impossible to meet all demand without relying on all or almost all of the available generation resources. The relatively high-cost generator operators -- those on the upper end of the supply curve -- know when these conditions are likely and can bid very high prices with a fair degree of confidence that they will be dispatched. If the market rule is that the generator that clears the market sets the price for the entire market, all generators benefit from that exercise of market power and consumers suffer. Thus, market prices can be manipulated by one or a very few sellers. Until all the pieces of a well-functioning competitive market are in place, there may be a need to place some limits on price levels in these conditions. Generation entry is spurred by the price signal that results from a well-functioning market. But if a high market clearing price is pegged by market power, such an extreme price does not serve a legitimate market function.

This cause of price spikes has been observed since the Commission approved the operation of auction markets with a single market clearing price. Perhaps we should reexamine our existing market power standards, which rely upon a generation dominance analysis. Is it sophisticated enough? Perhaps we should fine tune our market power analysis so that we have a better chance to catch the potential for such behavior *ex ante*. And we should take a hard look at whether the single price auction is appropriate in high demand or short supply conditions.

Another critical issue is demand responsiveness. This is a standard means of moderating prices in well-functioning markets, but it is all but absent from electricity markets. When prices for other commodities get high, consumers can usually respond by buying less, thereby acting as a brake on price run-ups. Without the ability of end use electricity consumers to respond to prices, there is virtually no limit on the price that suppliers can fetch in shortage conditions.

We must urgently seek ways to increase demand responsiveness. There are two aspects to this. One is showing an accurate price signal to the consumer before consumption decisions are made. The second is the ability of the consumer to react to the price signal. The first may be addressed by appropriate metering and communications, and that is the easiest part of the equation. However, residential customers cannot easily respond to price signals. I don't believe any of us want to sit at home watching the hourly price signal so we know whether we should postpone dinner or adjust the thermostat. The capability for residential and even commercial customers to adjust consumption lies in so called "smart houses" or "smart buildings" that allow computers to adjust the operation of certain equipment in response to market prices and "strike price" instructions.

Until that technology has penetrated a large part of the market, I think electricity providers should concentrate on arrangements that compensate large industrial and large commercial customers for reducing consumption. That will provide the biggest bang for the buck and may even capture enough of the demand curve to help discipline price run-ups. It has also been suggested that RTOs operate demand-side markets where demand aggregators bid negawatts. All options are on the table. All reports I have seen have emphasized this lack of demand responsiveness as a critical problem. We should attempt to solve it.

Another area that needs attention is risk management. In some instances, especially California, there seems to be an over reliance on the spot market. Spot markets are almost by nature volatile. While spot markets are appropriate as the venue in which to secure limited portions of needed supply, they should not be relied upon for most or all of the supply portfolio. Yet in some instances the spot market is relied upon almost exclusively. The painful results are almost predictable. The lack of hedging or forward contracting may be due to regulatory restrictions, poor incentives or just plain ignorance. Whatever the reason, regulators must ensure that everyone on the demand side of the market is appropriately incented or informed regarding hedging. Surely a balanced portfolio of long-term and short-term supply is the goal of well-functioning markets.

I continue to strongly believe that the development of well structured Regional Transmission Organizations is a necessary platform on which to build efficient electricity markets. Such markets require open access to an efficiently organized transmission grid. I believe that discrimination in access is still a problem, and I believe that utility-by-utility approach to grid management is inefficient. RTOs that meet the requirements of Order No. 2000 will help ensure access to large power markets, better transmission pricing, improved regional planning, and improved congestion management.

Having said that, I realize RTOs are not a panacea. Indeed, some of the markets in which the Commission has had to intervene have ISOs. However, the problems that the Commission has needed to address are related to market design, not transmission grid operation. I do believe we need a more focused debate on the appropriate relationship of RTOs and market operations. I know this is an ever-present issue in California between the ISO and the PX. And EPSA wants RTOs out of the market operations business.

We must adopt consistent market rules within a trading region. We know for a fact that resources will trade into the market that is most favorable to them. Trade should be based on true economics, not the idiosyncracies of differing market rules.

Ensuring that all of the elements of a well-functioning market are in place is a tall order, but we are obligated to do it. How do we go about it? One thing I would suggest is to learn from those markets that appear to be functioning well. PJM comes to mind.

I also know that state and federal authorities must form a partnership for ensuring well-functioning markets. Neither the FERC nor state policymakers, acting in isolation from each other, can solve all market flaws because our respective jurisdictions are sharply delineated under existing law. State policymakers cannot effectively define or police market power in interstate wholesale markets. They cannot require a wholesale market structure, based upon an efficiently operating interstate transmission grid, that will produce just and reasonable rates. These are federal responsibilities. By the same token, under existing law the FERC cannot site the generation and transmission facilities that are necessary to bring supply and demand into equilibrium, and has no direct authority to require purchasers of power to hedge price volatility risk in forward or financial markets. These are state responsibilities. Both federal and state policymakers have a role in pursuing policies that will facilitate an effective and price-dampening demand side response. We must work together to solve the problems at hand.

I have spent most of my time this morning discussing how we should move forward by ensuring well-functioning markets. But we all know that is a long-term effort, and markets in some regions are here and now and we must deal with them. What to do in the meantime before we have all the parts in place?

Some are suggesting that we are going to have to live with some form of price caps or bid caps as stopgap measures. I certainly do not relish this idea. I am aware that any sort of cap or intervention waters down the price signals we need for bringing about new supply and for hedging. While I firmly believe that price signals from a well-functioning market should be sufficient to attract generation, until we have good markets, one could question whether we can rely on the resulting prices as appropriate signals. And consumers do not want to bear the brunt of the price that results from flawed markets.

All I can say is that I am open to all suggestions, both long-term and short-term. How can we both protect consumers and shape up these markets at the same time?

Congress could provide a great deal of help by passing legislation mandating reliability standards, giving the Commission jurisdiction over all transmission, giving the Commission transmission siting authority, and shoring up our authority to detect and mitigate market power in interstate markets.

Ultimately, however, we must solve these problems if we are to ensure that markets produce just and reasonable prices. And we must proceed with a sense of urgency.

III. Conclusion

Now I could stand up here and blame others for market failures. I could blame state policymakers for not siting needed generation and transmission facilities. I could blame generators and transmission owners for the exercise of market power. I could blame consumers for not understanding market volatility. But I won't: I'd rather work for solutions.